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Reforming Labor Market Institutions: Unemployment Insurance and Employment Protection

Olivier Blanchard

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50 Memorial Drive
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Olivier Blanchard*

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Abstract

This paper explores the characteristics of both optimal and actual unemployment insurance and employment protection. It then sketches potential paths for reforms in both rich and middle-income countries. It reaches three main conclusions:

There is a role for both state-provided unemployment insurance and employment protection.

In rich countries, one challenge is to combine unemployment insurance with strong incentives for the unemployed to take jobs. Financial incentives are unlikely to be enough at the low end of the wage scale. The other challenge is to redefine employment protection by reducing administrative constraints and judicial intervention, and relying more on financial incentives.

In middle-income countries, the main challenge is to move from the current system of high severance payments and employment protection to a system of state-provided unemployment benefits and lower severance payments.

Modern economies are characterized by high levels of job creation and job destruction: Such reallocation is central to productivity growth.

With job destruction comes, however, the risk of unemployment for workers. And based on both historical and cross-country evidence, there are good reasons to believe that private markets, left to themselves, do a poor job of protecting workers against unemployment risk. This suggests a potentially welfare–improving role for state intervention, through the joint design of unemployment insurance (which determines the pain of being unemployed), and employment protection (which determines the probability of becoming unemployed).

Designing and putting in place the right institutions, be it employment protection or unemployment insurance, is a complex task. The evidence is that many rich countries, particularly in Europe, have done a poor job. The mistakes they made have led both to poorly functioning labor markets, and to high unemployment.

It is therefore essential to take a step back and think about the optimal design of labor market institutions, unencumbered by history or political economy considerations. Having taken that step, one can then attempt to sketch a path of reforms, a path to go from here to there. The "here" and the "there" vary across countries. European countries already have a complex set of labor market institutions; reforms mean transforming existing institutions. Poorer countries, such as those in Latin America have more embryonic labor market institutions to start, and more limited institutional capability; reforms mean putting in place new, potentially simpler, institutions.

The goal of this paper is to explore these themes. Section 1 sets the stage and reviews the rationale for state intervention in the labor mar-

ket. Section 2 offers an explanation of how, in Europe, desirable goals have led to flawed institutions and bad labor market outcomes. Section 3 turns to the optimal design of unemployment insurance and employment protection. Section 4 then explores paths for reforms in rich countries, i.e. Europe. Section 5 does the same for poorer countries, such as Latin America. Section 6 concludes.[1]

1 The Rationale for State Intervention

Few economists would argue against (at least some) state intervention in the labor market. One can think of a number of relevant dimensions here, where market outcomes may be either inefficient, or socially unacceptable, or both. Collective bargaining may lead to both inefficient and socially unacceptable outcomes, implying the need for the state to define rules regulating bargaining. Low–skill workers may have a productivity lower than what society considers a "living wage", implying the need to provide additional income to those workers. Markets may do a poor job of insuring workers against unemployment, implying the need for the state to provide unemployment insurance and define rules regulating separations. In this paper, I shall concentrate only on this last dimension. My excuse is that it is a central dimension, and I have not thought enough about the others.

1. Two caveats: (1) As will be clear to the reader, what follows is a combination of conclusions based on formal work with Jean Tirole (see [2] for some of the theory, [1] and [3] for applications to France and to the Netherlands respectively), of tentative conclusions from work in progress, and of more or less educated guesses. It is very much in the nature of a progress report. (2) I know French institutions much better than those of other countries. The conclusions of this paper are likely to be overly influenced by the French experience.

The historical evidence (from rich countries before the provision of state-provided insurance), together with the cross country evidence (from poorer countries without state–provided unemployment insurance) strongly suggests that, left to itself, the labor market does a poor job of protecting workers against unemployment. To think about whether and how the state might do better, it is important however to identify the sources of this failure.

Start with the workers themselves. The scope for self–insurance by workers, through accumulation and decumulation of savings to prepare for unemployment, is limited. Savings can do a good job in the case of high probability, small loss, events where the law of large numbers comes into play. They can also do a good job in the case of largely predictable events, happening far on the horizon, such as retirement. They can do at best a mediocre job for small probability events implying large losses, such as the loss of a job: They do poorly against events happening early in working life, before workers have had time to build up savings. They do poorly against events happening late in working life, when workers may have a hard time getting another job, and, in any case, have little time to replenish their savings.

Firms are the next natural candidates for providing unemployment insurance to the workers they layoff. But they also face a number of constraints. Small, single-owner firms are likely to inherit the risk aversion of their owners, and are thus in a poor position to insure workers. Larger firms often face constraints in financial markets, and may have shallow pockets. Even those firms which we can treat as risk neutral face other obstacles: They are in a poor position to assess the labor market situation of the workers they have laid off, let alone

monitor their search behavior. Under those conditions, providing insurance directly is likely to be unattractive.

Third parties, say private insurance companies, are in a better position to diversify risk, and thus, at least on those grounds, in a better position than firms to insure workers. But, unless they have better monitoring capacity than firms, they face the same problems in checking the employment status and search behavior of the unemployed. And, unless they can monitor the productivity of jobs and workers (which they cannot), they face an additional problem relative to firms: The provision of unemployment insurance to workers affects the separation decision of firms. The more generous the insurance and thus the payment to workers in case of separation, the higher the rate of separation, the more costly it is to provide insurance. This again makes provision of insurance unattractive.

All rich countries today have some form of state–provided unemployment insurance, so it is hard to know what private arrangements would emerge today in the absence of such insurance. (Before the state provision of insurance, unions and other worker organizations sometimes acted as third parties, providing limited insurance, typically with strong monitoring of their unemployed members.) One has to turn to poorer countries, where state–provided unemployment insurance is often absent. Leaving aside infra-family transfers—which clearly play an important role—arrangements typically take the form of severance payments by firms, either imposed by law or offered by the firms themselves. Severance payments eliminate the need to monitor the status and search effort of laid off workers. But they provide only mediocre unemployment insurance. In particular, being lump sum,

severance payments provide no insurance against unemployment duration uncertainty.

2 The Mistakes of Europe

One can trace many of the labor market problems of Europe to flawed attempts at achieving a desirable goal, namely the protection of workers against unemployment.[2]

2.1 Employment Protection

(1) Employment protection has been aimed at protecting existing jobs, at reducing job destruction.

Protecting existing jobs sounds like a good idea, surely one with strong political support. Collective layoffs, even if they account for a small proportion of total separations, are highly visible and often lead to long spells of unemployment. If unemployment is painful, why not try to reduce its incidence by reducing job destruction?

Not surprisingly however, the idea is less good than it sounds: The anticipation of higher separation costs makes it less profitable to create new firms, to try new and risky ventures. It reduces job creation.

2. The usual and important caveats apply here. Europe is not an homogenous whole: Today, while the large European countries still have high unemployment, many of the smaller ones have low unemployment. And, even in those countries with high unemployment, some reforms have taken place since the mid 1980s. What follows is a bit of a caricature, but a useful one.

Compared to the direct effect of employment protection on job destruction, this induced effect on job creation is nearly invisible: Jobs destroyed (or saved) are easily identified; jobs not created are not. But it is present, and it has important implications:

Employment protection may actually increase rather than decrease unemployment. The decrease in job destruction lowers unemployment; the decrease in job creation however increases it. In theory as well as in practice, the effect on unemployment appears ambiguous.

Employment protection changes the nature of unemployment. Lower job destruction reduces the incidence of unemployment; lower job creation increases the average duration of unemployment. With the increase in unemployment duration comes an increase in long-term unemployment. And, with long-term unemployment, come high human costs, ranging from the loss of skills, to the loss of self-confidence, to the loss of morale.

Employment protection has an adverse impact on productivity. Much of the microeconomic evidence on productivity growth gives a central role to the process of job creation and job destruction. More productive firms replace less productive ones; more productive jobs replace less productive ones. Lower job creation and lower job destruction delay or slow this process, and thus have an adverse effect on the level of productivity, and perhaps even on the rate of productivity growth.[3]

(2) Equally important is the form employment protection has taken in most European countries.

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3. To be fair, I feel however that this last empirical connection has not yet been convicingly established.

In general, one should distinguish between three forms of employment protection: Severance payments to the workers, direct payments to the state, and administrative and judicial constraints and costs, which go neither to the workers nor to the state.

Much of the actual and perceived cost of employment protection in many European countries actually comes from the third. In France for example, firms that layoff more than a certain number of workers have to go through a series of time-consuming steps. These include meetings with representatives of workers, the design of a plan aimed at finding jobs for workers in other firms, and so on. On the judicial side, the layoff decision of the firm can be and often is challenged in court. For example, the economic rationale given by the firm for the layoffs can be rejected by labor judges, and their decision can come after many years. Taken individually, many of the steps appear reasonable, and designed to alleviate the pain of unemployment. In effect, they introduce substantial uncertainty as to the final outcome and cost of layoff decisions. This uncertainty, which benefits neither workers nor firms, appears to have a large impact on job creation decisions.

2.2 Unemployment Insurance

Unemployment insurance has been aimed at helping the unemployed survive unemployment, rather than at getting them back into jobs:

On the one hand, the nature of unemployment in Europe, and the large proportion of long term unemployed, have created strong political pressure to extend more or less indefinite support to the unemployed, be it through social insurance or social assistance.

On the other hand, state-run unemployment agencies have been reluctant to condition unemployment benefits on search effort, and even more reluctant to condition benefits on a willingness to take an acceptable job if offered.

This combination of long-lasting and unconditional benefits has led many of the unemployed to exert low search effort, at least early in their unemployment spells. More visibly, it has led to unemployment traps at the low-wage end of the wage distribution. When account is taken of the various in-kind and cash benefit programs designed to help the non-employed, taking a job at the minimum wage, especially a part-time job, is often financially unattractive: The effective marginal tax rate sometimes exceeds one. Low search effort and unemployment traps have further contributed to increase long term unemployment, and the overall unemployment rate.

2.3 Reforms at the Margin

Flawed as they are, existing labor market institutions form a coherent whole. High employment protection leads to long duration unemployment. Long duration unemployment in turn increases the demand for employment protection.

In that context, reforms have proven hard to achieve, and have sometimes turned out to be counterproductive.

The expansion of the scope for temporary contracts provides an interesting example. In order to decrease employment protection without running into the opposition of workers already protected, many European countries have attempted to reduce employment protection at

the margin. They have allowed firms to offer, under certain conditions, temporary contracts to their new hires. At the end of such contracts, firms can layoff workers with small severance payments, few administrative steps, and limited judicial recourse by workers. In some countries, the conditions under which firms can offer such contracts have been fairly generous, and the proportion of temporary contracts is high. In Spain, for example, temporary contracts account for roughly 30% of employment, and 90% of new hires. In other countries, conditions have been more limited, and the proportion of temporary contracts is smaller. In France for example, temporary contracts account for 12% of employment and 75% of new hires.

Given the political constraints facing any across-the-board reform of employment protection, such reforms at the margin would appear to be a good idea. They have indeed increased the flexibility of firms in adjusting employment, at least at some margins such as seasonal movements. They have made it less risky for firms to hire new entrants, i.e. to hire workers with no employment history. But this has come at two substantial costs. First, they have further insulated workers under permanent contracts from fluctuations in employment, increasing their bargaining power and decreasing the response of wages to unemployment. Second, they have made it very costly for firms to keep workers at the end of their temporary contracts: Keeping a worker implies giving that worker a permanent contract, and the employment protection which comes with it. Unless the worker is exceptional, the firm has an incentive to let him go, and hire another temporary worker. And, if the probability that the worker will not be retained is high, the incentives for the firm to give him training are limited. The result has been an increasingly dual labor market. In France, the evidence is

that entrants typically go through a long succession of dead-end temporary jobs and unemployment spells before landing a regular job, and that the length of time to obtain a permanent job has actually increased since the introduction of temporary contracts.

3 Optimal Unemployment Insurance and Employment Protection

If one were free to design unemployment insurance and employment protection from scratch, what would one want to put in place? The question is obviously politically naive; but as our previous discussion suggests, reforms driven by political constraints may go in the wrong direction. It is essential to have a clear sense of the ultimate goal.

3.1 Unemployment Insurance

When we discussed in Section 1 the failure of private markets to provide adequate unemployment insurance, we identified a number of problems facing either firms or private third parties as providers of insurance. Is there any reason to think that the state can do better?

The answer is yes. First, as a very large third party insurer, the state is more likely to be able to diversify unemployment risk. Second, by having a ready administrative infrastructure, it is in a unique position to monitor the status of workers. for example to assess whether they are still unemployed or have found a job. It may also be better able than other third parties to monitor and condition benefits on search effort.

All this does not imply that unemployment insurance must be the exclusive domain of the state. The state may, for example, provide its administrative infrastructure to an agency jointly run by workers and firms, and one observes variations along these lines across different European countries. But it implies that the state must play an important role in the provision of unemployment insurance. So, for the rest of this discussion, I shall think of insurance as being state-provided.

The state still faces many of the problems that would be faced by firms and by private third parties.

(1) It must monitor not only the status of workers—employed or unemployed—(something which, in rich countries, is relatively easy to do), but their search effort.

Here one has to recognize the fact that, at the bottom of the wage distribution, financial incentives to take a job if unemployed are inevitably limited. Both the level of benefits and the lowest wage are likely to reflect what society considers as the minimum acceptable standard of living, and thus to be close to each other.

If this is the case, the provision of benefits must be made conditional on the acceptance of a job if such an "acceptable" job is available. The principle here is simple, but its implementation is not:

It requires in particular the definition of what an acceptable job is, and how this definition changes with the duration of unemployment. An interesting issue arises here from the possibility of on-the-job search. If searching while on a job is feasible (which it typically is), the class of "acceptable jobs" should be larger. In other words, it may be better to force somebody who is unemployed into a mediocre job, from which

he can search for a better one, than to allow him to stay unemployed.

It also involves giving the proper incentives for the employees of the unemployment agency. If the agency is run by the state, one might guess that state employees have few incentives to force the unemployed into jobs. This is indeed what one observes. If, instead, the agency is privately run, and its employees are rewarded according to their job placement record, the unemployed may be forced into jobs which are truly unacceptable.

(2) It must address the distortion of the separation decision implied by the presence of unemployment insurance.

Recall the nature of the distortion: The higher the unemployment benefits given to the worker if laid off, the higher the threshold level of productivity below which the firm will lay the worker off. The reason: If the worker is laid off, the firm and the worker taken together receive a transfer from the insurance agency, namely the unemployment benefits paid to the worker; this distorts the decision of the firm.

To take a simple example, suppose (counterfactually) that, if laid off, the worker remains unemployed forever, and derives no utility or disutility from being unemployed. Then, the socially efficient decision would be to keep the worker employed so long as his productivity is positive. But, from the point of view of the worker and the firm, it is optimal for the firm to layoff the worker as soon as productivity is below unemployment benefits. The implication is that there will be too many layoffs.

Can the state limit or undo this distortion?

If firms are risk neutral and have deep pockets, then the state can undo the distortion in a very simple way: By charging the firms for unemployment benefits paid to the workers they layoff. This can most easily be done ex-post, by just sending the bills to the firms as workers go through their unemployment spell and collect unemployment benefits.

Under this arrangement, the state no longer provides insurance. Firms do. The state only acts as an intermediary, better able than other third parties to solve some of the information problems associated with the provision of this insurance. Firms take into account the cost of unemployment insurance. As a result, they have incentives to layoff workers with the best chances of reemployment, and to help them find employment.

If firms are risk averse, or have shallow pockets—i.e. face financial constraints—, then fully charging firms for unemployment benefits may no longer be optimal. By their very nature, layoffs are more likely to take place in relatively bad times for the firm. Asking firms for payment in bad times may increase the risk faced by the firm's owners, or may put the firm into more financial difficulty, or force the firm to take inefficient decisions.

One partial solution is to separate the timing of payments to the laid-off workers by the agency from the timing of payments by firms to the agency. Bonus-malus systems, in which firms that layoff more face higher contribution rates in the future, are a standard way to combine the provision of insurance with better incentives. Accumulation of unemployment benefit balances by firms, and payments of these

balances over time are another and closely related way to proceed.[4]

This may however not be enough, in which case it may be optimal to charge firms less than the full amount of unemployment benefits, and to finance the rest in some other way, for example through payroll taxes. The distortions this creates at the separation margin may be more than offset by the reduction in risk or financial difficulties faced by firms.

Can one be more specific as to the relative role of "layoff taxes" (the contributions by firms to the agency, proportional to the benefits paid by the agency to the workers laid off by the firm) and, say, payroll taxes? Not easily, although my guess is that the proportion financed by layoff taxes should be high. This is based on the notion that, while layoffs associated with major financial difficulties for firms, including bankruptcy and firm closings, are the most visible, they account for a small fraction of all layoffs. Most layoffs take place in firms which are not in financial difficulty, where the assumption of risk neutrality and deep pockets may be quite reasonable.[5]

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4. This is the principle behind the "reserve ratio" system used in many U.S. states. Leaving aside the many complicated details, the principle is simple: Each firm has a running balance with the state unemployment agency, with contributions by the firm to the fund on one side, and benefits paid by the agency to the workers laid off by the firm on the other. Once a year, the state computes the net outstanding balance, and requires the firm to pay some proportion of this outstanding balance over the following year. The factor of proportionality depends both on the net balance of the firm, and the net balance of the state fund as a whole. Ignoring discounting, and the various ceilings that limit contributions (all these considerations being very relevant in practice), firms eventually pay the full cost of unemployment benefits for the workers they lay off. The factor of proportionality determines how the timing of payments depends on current and past layoffs.

5. There are other relevant dimensions here, some of which are discussed in [2].

To summarize: There are good reasons to have the state provide unemployment insurance. This system must make unemployment benefits conditional on acceptance of jobs if available. And unemployment benefits must be financed, in part or in total, by proportional contributions from firms.

3.2 Employment Protection

(1) The discussion of unemployment insurance we have just gone through has a straightforward and important implication for the design of employment protection: Firms that layoff workers should pay a "layoff tax," accounting in part or in total, for the unemployment benefits paid to the workers they layoff.

Such a tax is clearly a form of employment protection. Although the payment does not go directly to the workers, it (optimally) deters firms from laying off workers. Put simply, employment protection (in this form) is part of the optimal set of labor institutions.

(2) Should there be severance payments. that is direct payments to workers, in addition to these layoff taxes? To answer this question, it is useful to distinguish between two costs, the cost associated with losing a job, and the cost associated with becoming unemployed. (A worker who finds a job upon being laid off suffers the first, not the

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One of these is the extent to which different taxes affect the wage in different ways. Other things equal, a layoff tax, which makes it more costly for firms to layoff workers, increases the bargaining power of workers. and to the extent that wages are set ex-post, may increase labor costs more than would a payroll tax. This provides an argument for relying more on payroll taxes, and less on layoff taxes, in the financing of unemployment benefits.

second.) So far, we have focused on the implications of the second. Let's now think about the implications of the first.

Losing a job often has a psychological cost: The loss of a long-held job, even if the loss is not followed by unemployment, can lead to the loss of a network of workplace friends, to health deterioration, and to a loss of self esteem. This cost is however not per se an argument for severance payments: Financial payments cannot offset the psychological cost.[6] It is an argument instead for decreasing the incidence of layoffs through a higher layoff tax. If, as is plausible, the psychological cost is increasing with seniority in the firm, this suggests making the layoff tax an increasing function of seniority.

Losing a job may also have a financial cost: There is substantial evidence that, in many jobs, the wage profile paid to the worker as a function of his or her seniority is steeper than his or her productivity profile. In other words, workers are relatively underpaid early in their tenure, overpaid later on. If this is the case, then losing a job can have a large financial cost for a worker with seniority. And, in contrast to the case of unemployment insurance, the firm is in a good position to insure workers against this financial cost: The cost is incurred at the time of separation, relatively easy to assess, and payment can take the form of severance payments.

How should the schedule of severance payments look in this case? A tentative answer is that it should depend positively on seniority, and negatively on distance from normal retirement age. The higher the seniority, the higher the likely financial cost. The closer to retirement,

6. More formally: Insurance can only equalize the marginal utility of consumption. It cannot insure against psychological costs.

the lower the cost (Other benefits being equal, being laid off one year before retirement just anticipates an expected outcome by one year.)[7] This suggests a schedule increasing, and then decreasing, in seniority.

It is not clear however why the level and schedule of severance payments, and in general, the many other dimensions of employment protection (advance notice, retraining) should not be left to contracting between firms and workers. Ex ante, firms have the incentives to offer the best separation package they can to the workers they hire. Advance notices will clearly be valued by workers, as will retraining. If so, they will be reflected in lower wages, and lower labor costs. The role of the state in this case may simply be to put a number of basic minima in place, and then to make sure that whatever contracts are entered by firms and workers—in individual and collective bargaining—are enforced.

(3) Suppose that unemployment contributions by firms are mostly financed by layoff taxes (rather than payroll taxes). Should these layoff taxes be applicable as soon as the worker is hired, or should they be phased in? Put another way, should the layoff taxes paid by the firm be the same if it lays off a worker with six months seniority or if it lays off a worker with six years seniority (assuming both workers have the same labor market prospects after the layoff)?

One has a sense that there should be some phasing in, for at least two reasons. First, to reduce the problem of adverse selection arising from workers who intend to be hired and then force the firm into laying

7. This assumes that retirement and other benefits are fully vested, so the worker receives them even if laid off. If not, it may still be very costly to be laid off one year before retirement.

them off so they can receive unemployment insurance. Second, to give some time for the firm and the worker to explore the quality of the match and to separate at little or no cost if the match reveals itself to be a bad one. Both reasons suggest making layoff taxes a function of seniority, with full layoff taxes fully coming into play only after a certain number of years of seniority.

To summarize: Employment protection, in the form of layoff taxes covering part or all of the unemployment benefits paid to workers, is the natural counterpart of unemployment insurance. These layoff taxes should increase with seniority, being low at the start of employment, and reaching their normal level after a few years of employment. Severance payments are also justified, to compensate for the financial costs associated with the loss of a job—as oppposed to the financial costs associated with unemployment. For the most part however, these payments and other aspects of separation should be left to bargaining between firms and workers, rather than imposed by the state.

4 Reforms in Rich Countries

Comparing optimal institutions to actual institutions in rich countries (i.e. Western Europe) suggests three main dimensions of reform:

(1) A reform of unemployment insurance, to increase the incentives for the unemployed to take jobs, if available.

Current systems rely for the most part on financial incentives. By necessity, these are likely to be weak at the low end of the wage distribution. There are two ways to force the unemployed back into jobs.

The first is to decrease and eventually end benefits after some time. This however runs the risk of taking away unemployment insurance from those who need it most. The second is to force the unemployed to take jobs if those jobs are available, and provide insurance otherwise. This is a much better option.

This reform is technically difficult. It requires defining what an acceptable job is and how this definition evolves with unemployment duration. It requires making sure that the unemployment agency has the proper incentives to get workers to take jobs. Here however, a number of countries have been experimenting, and there is an increasing body of evidence on which to rely.

Is this reform politically feasible? It may be, because it provides in effect better insurance than the existing system. While forcing the unemployed into jobs if such jobs are available, may be perceived as tough on the unemployed, the converse side of the reform is that, if no jobs are available, the unemployed receive unemployment benefits for as long as they need. This implies for example that workers in distressed areas are likely to be better off than they are under the current system.

(2) A reform of employment protection, with a larger role for financial incentives (in the form of layoff taxes), and a reduction in the other dimensions of state-imposed employment protection.

In most European countries today, unemployment insurance is financed through payroll taxes. As we have seen, insurance should be financed, at least in part, through layoff taxes.

On the other hand, many aspects of the current system of employ-

ment protection should be eliminated, or, more specifically, left to contracting and bargaining between workers and firms. For example, there is no obvious justification for letting judges assess whether layoffs are economically justified. So long as firms respect the contracts signed with individual employees or with unions, firms should be free to adjust their level of employment.

This reform is not technically difficult, although it involves major changes in labor law. Is it politically feasible? The potential trade-off between the increase in layoff taxes—which obviously acts as a deterrent to layoffs— and the decrease in the role of the judicial process in employment protection, may be attractive to both workers and firms. (The judicial uncertainty associated with the layoff process is costly for both firms and workers. The decrease in uncertainty associated with such a shift suggests that both sides may benefit from the reform.) It is clear however it may not be politically easy: The evidence suggests that the notion of shifting from judicial to financial employment protection is strongly at odds with the widely held notion that workers are stakeholders in the firm and should be involved in collective layoff decisions.

(3) A shift back to a single labor contract, with workers' rights increasing in seniority.

As we have seen, the dual system of temporary and regular contracts introduced in many European countries is perverse, creating two classes of workers, and making it hard for entrants to obtain a regular job. The source of the problem is the threshold effect coming from the large increase in employment protection the firm faces if it wants to keep a worker beyond the end of a temporary contract.

The natural solution is to eliminate this threshold effect, by having a smoother transition, in which workers' rights increase more smoothly with seniority in the firm. If for example, the reform of employment protection discussed above is implemented and firms are subject to layoff taxes, one can think of an increasing schedule of layoff taxes, with a low tax rate in the first year after hiring, and the full tax rate after, say, five years of seniority. Under such a schedule, firms will be willing not only to hire, but to keep new entrants.

Is that reform politically feasible? The answer is that it may be. On the one hand, it increases employment protection and job prospects for those workers currently on temporary contracts. On the other, it is true that it decreases employment protection for those workers with permanent contracts and low seniority. These workers however can easily be grandfathered—i.e., protected by the old employment protection rules during a transition period. Thus, there may well be a majority in favor of reform.[8]

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8. A related argument underlied the introduction of temporary contracts in the 1980s. The argument was that, when the proportion of workers under temporary contracts became sufficiently high, there would be a constituency for a reform which reduced employment protection for workers under permanent contracts, and increased it for workers under temporary contracts. Some have argued that this was indeed the case in Spain at the end of the 1990s, when the number of unemployed workers and workers under temporary contracts exceeded the number of workers under permanent contracts. Whether or not this can happen depends on the rules under which temporary contracts can be offered. Under the rules currently in place in France, the proportion of temporary workers will remain too small to change the political equilibrium.

5 Reforms in Poorer Countries

Poorer countries find themselves in a very different starting position than does Western Europe. Most of them have either no or very limited state-provided unemployment insurance. They rely instead on high employment protection, with a combination of high severance payments and administrative and judicial constraints.

(1) As their institutional capability improves, many of these countries should be and indeed are introducing state-provided unemployment insurance.

It is unrealistic to expect them to be able to monitor search effort or to link benefits to job acceptance in the same way as richer countries. This suggests the desirability of a simpler system, with unemployment benefits decreasing with unemployment duration and eventually ending after some time. Such a system is still an improvement over severance payments, in two ways: It provides some insurance against unemployment duration. And it eliminates one of the risks facing workers under severance payments, namely that the firm is unwilling or unable to pay; this risk is transfered to the state, which is typically in a better position to go after the firm if needed.

For reasons we have already discussed, financing of unemployment benefits should be done, at least in part, through layoff taxes. This suggests therefore a reform in which direct payments from firms to workers (severance payments) are replaced in part by payments from firms to the unemployment agency, and payments from the unemployment agency to laid off workers.

The previous paragraph points to one of the dangers facing such a

reform. Namely that the unemployment insurance system is simply added on to the existing system of employment protection. It is important that, as state-provided insurance is put in place, severance payments be reduced; their role as unemployment benefits is no longer needed. Some recent experiences suggest that this risk is very much present, and is one that governments must avoid as they introduce unemployment insurance.

(2) A number of countries, worried about enacting a full fledged unemployment insurance system with the distortions it entails, have explored self-insurance by workers as an alternative. While details vary, this typically has taken the form of mandatory unemployment saving accounts, to which the worker and the firm must contribute while the worker is employed, and from which the worker can withdraw if and when laid off.

It is easy to see the appeal of such a solution. Recall that if workers can self insure, then there is no need for state-provided unemployment insurance, no need to monitor search effort, no need for employment protection, fewer distortions all around. Unfortunately, for the reasons discussed in Section 1, the degree to which saving accumulation and decumulation by workers can insure them against unemployment risk is very limited. The probability is too small, the pain too large, for savings to easily absorb the risk. The use of interest rate subsidies does not substantially change this conclusion.[9]

This is why, in practice, individual unemployment account systems typically include some additional state-provided insurance. This may

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9. Paradoxically, some of the mandatory saving schemes in place in Latin America actually pay below market or even zero interest rate.

take the form of allowing, for example, unemployed workers to borrow up to some ceiling either directly from the state or from financial institutions through a state guarantee. However, these additional provisions raise many of the same issues as does state-provided insurance. How much should the state provide or guarantee, and in what form? How do we make sure that firms internalize the cost of these guarantees to the state, and so take efficient layoff decisions? It would appear that a system of state-provided insurance is a simpler and more transparent way to proceed.[10]

(3) Poorer countries have a large informal sector. The decision by firms to operate in the formal or the informal sector is primarily an economic decision, based on the benefits and costs of informality. The issue in introducing any new regulation is whether and how this will affect the firms' choice, and perhaps drive firms to the informal sector.

If we think of the system of state–provided insurance as a more efficient replacement for the current system of severance payments, this should make it more appealing to be in the formal sector. Firms can now offer better insurance to their workers at the same cost. If state-provided unemployment insurance is only available to workers laid off from firms in the formal sector (firms that finance the unemployment insurance system through payment of payroll and layoff taxes), then the incentive for firms to become formal must increase with the introduction of state provided unemployment insurance.

This argument suggests that the introduction of state provided un-

10. Some of the proponents of unemployment accounts appear to have another goal, increasing aggregate saving. Even if the goal is desirable, it is doubtful that such restricted saving accounts are the right instrument.

employment insurance—if accompanied by a corresponding reduction of severance payments—should lead to a decrease rather than an increase in the informal sector. I suspect the argument leaves out a number of important other considerations; but it provides, I feel, a useful starting point for a discussion.

6 Conclusions

This paper has explored the nature and implications of actual and optimal unemployment insurance and employment protection. It has then sketched potential paths for reforms in both rich and poorer countries. A number of themes come out:

When one moves away from slogans about "labor market rigidities", and looks at imperfections in the labor market, it is clear that there is a role for both state-provided unemployment insurance and for employment protection.

In rich countries, one challenge is to combine unemployment insurance with strong incentives for the unemployed to take jobs. Financial incentives are unlikely to be enough at the low end of the wage scale. Instead, unemployment benefits must be made conditional on the acceptance of jobs if available. The other challenge is to redefine employment protection, by relying more heavily on financial incentives, in the form of layoff taxes, while shifting most of the other dimensions to contracting between firms and workers.

In poorer countries, the challenge is to move from the current system of high severance payments and employment protection to a system

of state-provided unemployment benefits, lower severance payments, while again shifting most of the other dimensions to contracting between firms and workers.

Can these reforms protect workers against unemployment risk, while achieving low unemployment, high reallocation, and high productivity growth? One would be foolish to give an answer with much certainty. But the experience of successful European countries, from the Netherlands to the Scandinavian countries, gives some ground for optimism.

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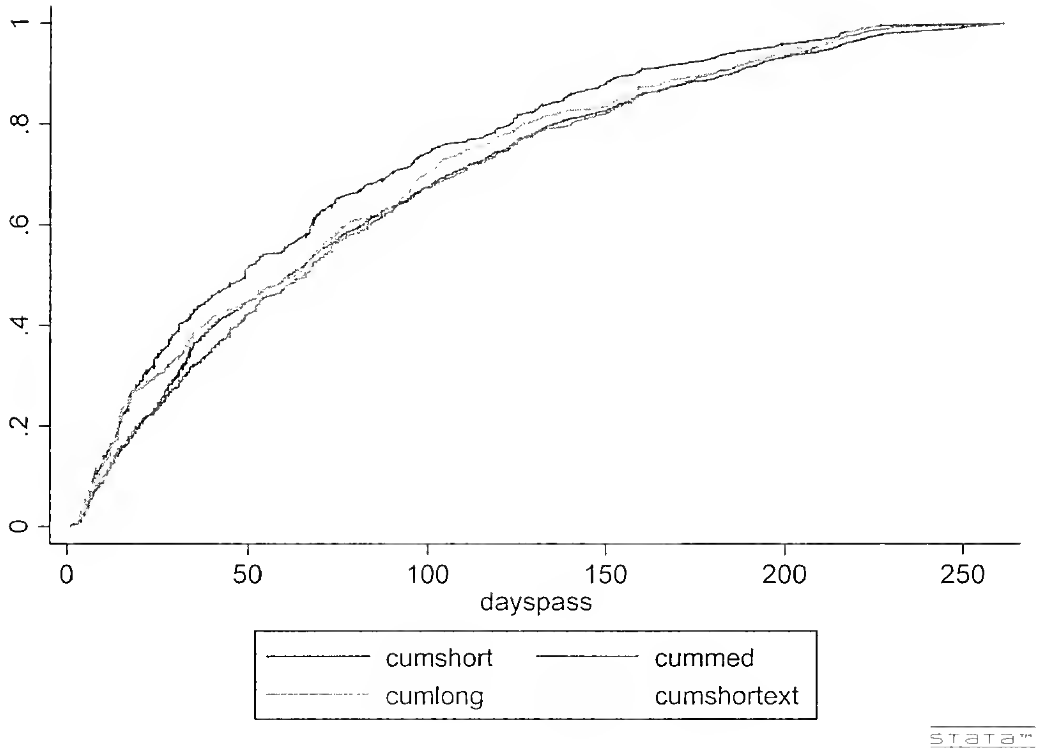
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